Cost Allocation

Perspectives for the Utilities Industry

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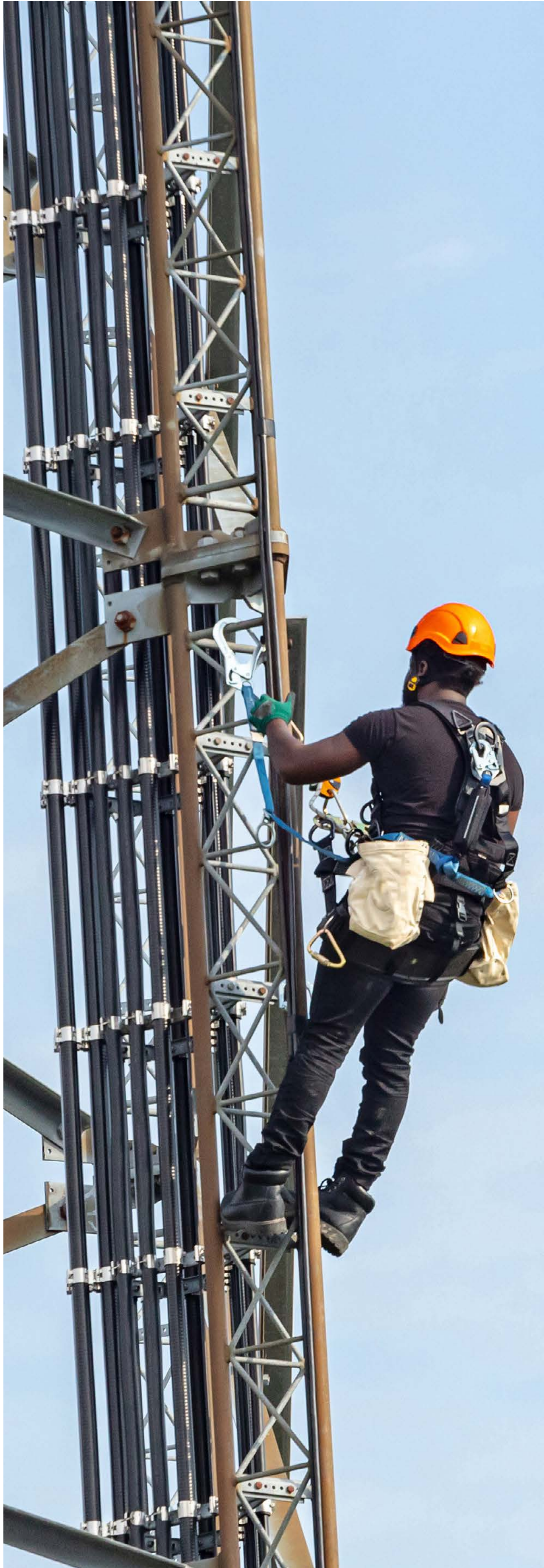

Introduction

The current climate for electric power utilities has been one of volatility. The industry has seesawed between increased power usage by consumers during work-from-home mandates and declining commercial and industrial usage as businesses folded during the economic downturn. The lack of stability in the source of demand has made rate setting and related cost allocations an increasingly complex undertaking. If electricity consumption normalizes over the next five years as the pandemic abates, utilities shared services companies (USSCs) will have an opportunity to transform their shared services allocation models to best serve their utility affiliates. From our work with utilities, we have uncovered ways in which the most forward-looking utilities are effecting broader business transformation and cost allocation strategies in sync with each other, with the Finance function playing a crucial role in this orchestration.

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A regulatory perspective

Since utilities markets tend to become natural monopolies, they are highly regulated. Regulators require utilities to build rate cases that comprise internal costs before obtaining regulatory approval and determining appropriate customer charge levels that align with approved rates.

The allocation of costs from USSCs for the services they provide must be managed with the expectation of regulatory scrutiny designed to spot overallocations to regulated affiliates. The concern is that overallocations could inflate affiliates' rate cases and trickle down to consumers as higher prices.

How do we move forward?

A complicating factor in building rate cases—and allocating costs—is the fact that parent utility groups often work with multiple affiliates that can be parsed according to one or more of three factors: (1) geographical zones of operation, (2) type of utility business (natural gas, electricity, water, etc.), or (3) where they fit in the utility value chain (generation, transmission/transportation, distribution, etc.). At the same time, it is common for parent utility groups to have nonregulated affiliates (e.g. real estate holding companies) that do not need rate cases to be built and submitted.

As USSCs deliver standardized processes such as accounting, billing, IT support, etc. to affiliates, they will want to consider shifting away from a wholly centralized model to a matrixed model encompassing decentralization of certain key services with their affiliates.

On a high level, such models should reflect the following attributes:

Transparency: Accommodate the demand for increased transparency into cost vs. value by demonstrating to affiliates that they are receiving value for costs through robust service level agreements (SLAs) and to regulators that the USSC is a lean organization with smaller cost pools to allocate.

Accuracy: Apply industry best practices that reflect accurate cost capture and bases for allocation.

Consistency: Ensure consistency of allocation across components of a service, e.g., labor- and non-labor-related costs.

Equitability: Allocate cost equitably by aligning service costs with volume of services received by each affiliate, through the right usage of resource units and cost allocation bases.

Actionability: Help internal management take action based on available cost data by providing links between costs and KPIs, for instance between labor cost measurement and utilization.

Accountability: Remember that, although value for cost should always be measured via appropriate KPIs and metrics, this attribute is even more critical for allocated costs.

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Cost allocation transformation strategies

As USSCs consider the most appropriate cost allocation structure for their circumstances, they will want to consider the following five transformation strategies:

1. Institute a matrixed organizational structure
2. Realign resource units
3. Employ modern cost allocation strategies
4. Enhance accountability in service level agreements
5. Foster greater affiliate engagement.

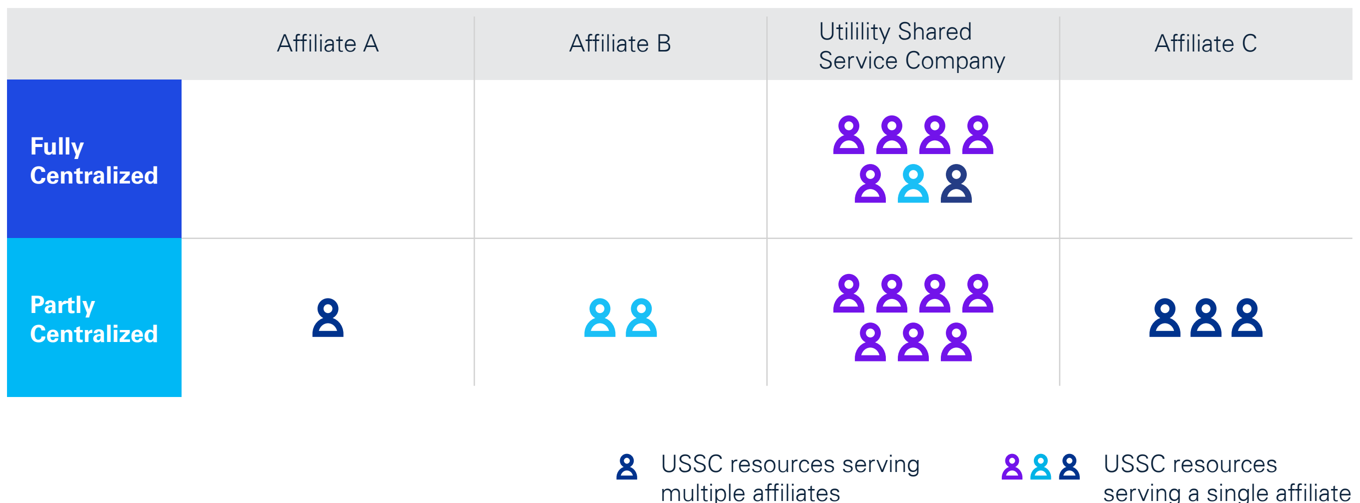
1. Institute a matrixed organizational structure

To give affiliates a greater sense of control over delivered services and associated costs, many leading utilities are transitioning from a centralized structure to a matrixed structure incorporating decentralized/federated functions housed within the affiliates, together with some specific centralized functions maintained at the parent utility.

Federated subfunctions inside affiliates would likely include back-office functions like finance, human resources (HR), IT, and marketing, as well as rebadged resources that are dedicated to a single affiliate (Exhibit A). If subfunctions don't exist in the affiliate, they can be created as federated subfunctions into which resources can be rebadged. For example, system administrators of an electricity-monitoring IT system that is used exclusively by one affiliate power utility would be better served by placing IT administrators inside a federated IT subfunction within the affiliate instead of among a larger pool of IT administrators within the USSC.

This model is validated by many affiliate leaders. "Affiliates complain that they don't have control of the services delivered and costs charged by central services," said the senior vice president of legal and regulatory strategy at a utilities multinational company. "So, it helps to move back-office resources under the affiliates for all resources whose work is dedicated to a single affiliate."

Exhibit A. The transition from fully centralized to matrixed



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The centralized functions within the USSC would still deliver standardized services to affiliates, which come with many benefits in terms of efficiency, effectiveness, and experience. However, it is important not to go too far with centralization as this runs the risk of an inflated USSC cost pool, bulky cost allocations to regulated affiliates, and more time and effort to document and justify in the rate cases. Conversely, it is critical to "guard against creating redundancies while building a federated model," according to the president of a utility consultancy interviewed by KPMG.

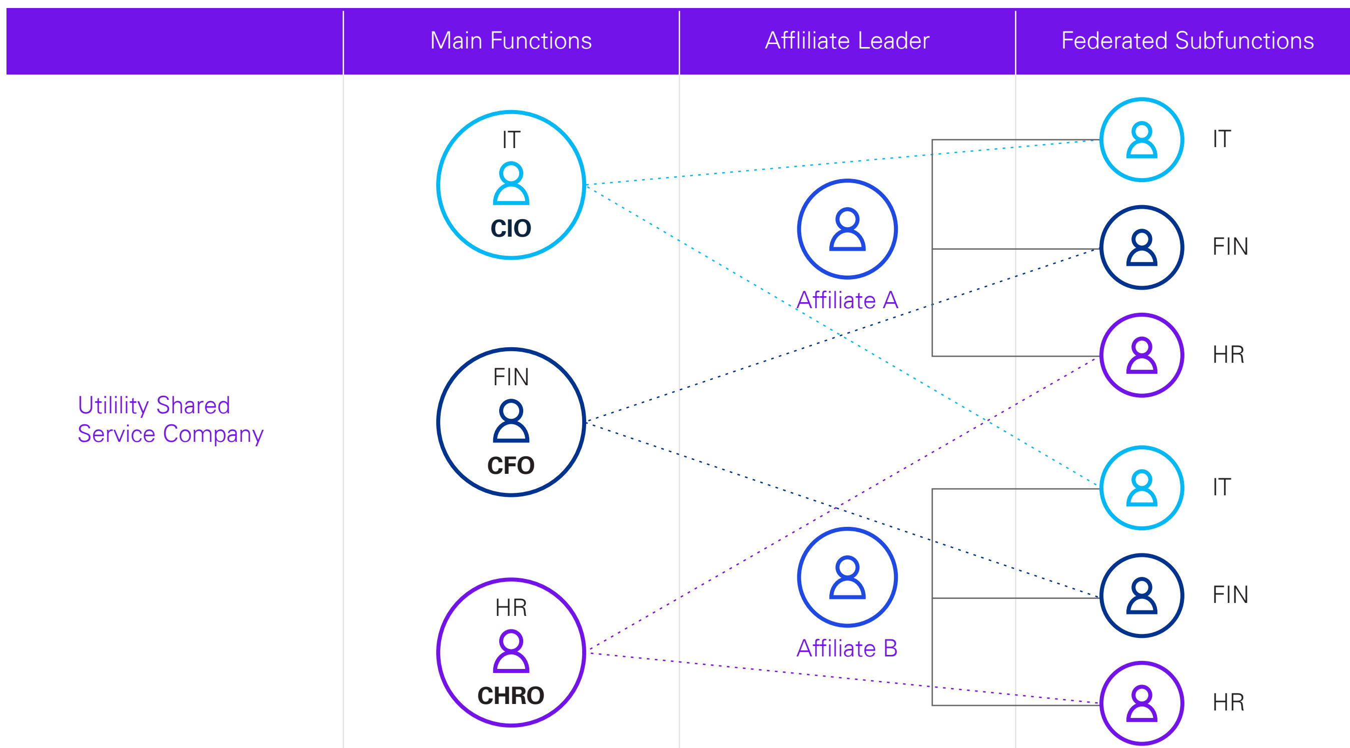
In terms of reporting, federated subfunctions will likely have a main line of reporting to their respective affiliates, and simultaneously have matrixed reporting (or a "dotted line") to the head of the main function in the USSC (Exhibit B). For example, the federated HR subfunction at a natural gas affiliate would have a direct reporting line to the CEO of the affiliate, and a dotted line to the CHRO (Chief Human Resources Officer) who resides in the USSC. The dotted line helps federated resources integrate with the rest of the function and allows for career paths that extend beyond the affiliate.

According to the vice president of operations of a utility multinational company, "When you think about finance resources in the affiliate subfunction, it should feel like a part of the larger finance function, which mostly sits in the service company. The growth path and mobility of federated resources are also important considerations."

In short, a matrixed cost allocation structure requires finding the sweet spot between centralization and decentralization.

The takeaway: USSCs structured to work in tandem with federated functions in the utility affiliates benefit from leaner cost pools and easier regulatory filings.

Exhibit B. Federated reporting structure



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2. Realign resource units

Utility service companies have numerous fixed costs, including labor costs. If resource units Resource Units are subject to high seasonality, USSCs will want to help them avoid dramatic fluctuations in cost allocation. This can be accomplished by adopting nonseasonal resource units while allocating cost components that are predominantly fixed in nature.

In doing so, RUs will be aligned more closely with actual cost drivers, such as the number of licenses or number of customers associated with an IT system. This is critical for avoiding skewed chargeback numbers, i.e., when certain affiliates are charged a higher price if another affiliate goes through a low season.

Many leading utilities are already finding success through this strategy. "We try to ensure that fixed costs are not allocated through highly variable resource units," says the vice president of operations of a utility multinational company. "If we didn't take this approach, the numbers affiliates are charged would be skewed throughout certain months of the year."

The takeaway: In the current environment, realigning resource units to avoid dramatic cost fluctuations and facilitating stable and predictable monthly chargebacks are critical parts of working with affiliates, particularly those that are highly regulated.

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3. Employ modern cost allocation strategies

Costs for shared services provided by USSCs fall into three broad categories:

- **Directly assigned costs** are for services provided to a single affiliate, such as for a stand-alone IT system.
- **Direct resource-unit-based allocated costs** are for services provided to multiple affiliates, requiring expenses to be precisely allocated based on direct resource units, such as IT system license fees where each affiliate has a different number of licenses.
- **Surrogate resource-unit-based allocated costs** are also for services provided to multiple affiliates, but the expenses are allocated through a surrogate resource unit instead of precisely allocated based on direct resource units. This would be most appropriate when, for example, IT support services costs are apportioned through a surrogate resource unit such as the number of IT users or number of support tickets.

Cost allocation practices employed by leading utilities companies include:

Using MMF for general costs: When allocating general costs such as senior management labor, modern utilities are now using general formulaic allocation methods such as the Modified Massachusetts Formula (MMF). The MMF is now generally recognized by regulators and, as such, is replacing the older method of allocating general costs through resource units such as the number of end customers at the affiliate. MMF considers the direct labor, capital investment, and gross revenue of each affiliate to ensure that affiliates are equitably allocated their share of the cost pool based on their stage in the business lifecycle, e.g., new companies versus mature ones, capital-intensive vs. labor-intensive, etc.

For affiliates, this method helps keep the general allocation more straightforward and balanced and avoids a skew toward any one organizational metric. In addition, for the USSC and Corporate entities, this helps capture the impact of tangible and intangible senior leadership activities and eliminates the need to burden senior leadership with timesheets.

Aggregating costs by service: A USSC might aggregate labor costs to allocate with one resource unit, such as through timesheets, or aggregate IT costs and allocate them based on the number of users, etc. A forward-reaching recommendation is to aggregate costs by service, and then allocate those costs on a common basis to the affiliate.

IT systems are a prime opportunity for aggregating costs. The most prevalent means of doing this is by allocating IT system costs by OEM contracts, e.g., number of licenses for ERP systems, number of customers for billing applications, level of revenue for finance applications, etc. Another method is bundling IT system costs with the services the system supports, e.g., for billing services, which involve both labor costs and IT system costs, the utility would bundle the costs together into one billing service cost and use a single method of allocating them. Finally, some utilities may want to bundle IT system costs with general IT hardware and software into a large IT system cost pool. Overall, this method provides greater transparency into the total cost of an IT service.

Applying blended labor rates: An advanced practice is to create blended labor rates based on service descriptions, instead of the traditional method of fully loaded costs based on the compensation level of the individual providing the labor. Blended rates can be benchmarked to the market to ensure equitable cost charges. This method ensures that different affiliates are charged a consistent cost for the same service.

For example, to determine a blended rate for processing an invoice, the USSC would compute the cost by multiplying it with the Full Time Equivalents (FTEs) involved in the activity, irrespective of their designations and fully loaded costs. One caveat is that a true-up would usually be required at the end of the period since the actual labor cost would be slightly different than the blended average rate. Based on inputs from industry experts, we see blended rates by designation as being a clean way of approaching costs, and something regulators are comfortable with.

The takeaway: Cost allocation strategies that illuminate cost vs. value can help ensure equitability of charges across affiliates.

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4. Enhance accountability in service level agreements

Captive shared service centers sometimes only have service agreements with the group companies they serve. Even if these agreements are referred to as "service level agreements," they don't always have specified metrics and service levels. With affiliates demanding service levels on par with the markets, however, there is a trend to contractually specify metrics and service levels similar to third-party outsourcing contracts. Measuring and reporting on performance measures internally will give affiliates transparency into the service levels for which they're being charged.

SLAs should encompass the following dimensions: timeliness, accuracy, checklist adherence, compliance, data integrity, cost to serve, productivity, customer satisfaction, etc. Reporting on these attributes will be of value not only to affiliates, but also to regulators.

The takeaway: Service level agreements are a prime tool for enhancing and enforcing accountability.

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5. Foster greater affiliate engagement

Affiliate customers should understand the USSC's communication and escalation protocols. With bespoke services such as legal, special consideration can be given to involve affiliates in scoping, go/no-go decisions, etc. This will allow affiliates to feel more ownership and collaboration when it comes to services and costs and reduce the risk that they will be presented with a "surprise" bill after services are rendered. And, if a performance management issue arises, having a clearly defined escalation mechanism will help maintain a healthy provider/affiliate relationship.

The takeaway: In a matrixed environment, instituting communications and escalation protocols are key to a positive provider/affiliate relationship.

First steps

Utilities seeking to modernize their cost allocation systems and adopt best-in-class practices should start by asking themselves the following questions across cost pooling, apportionment, and distribution:

Cost pooling: Make cost pools leaner and more precise by analyzing how they are built up in the first place.

- Where are costs incurred?
- How are costs captured and recorded?
- How are labor and nonlabor costs measured and rolled up into cost pools?
- When are costs directly charged, and when are they aggregated into cost pools?

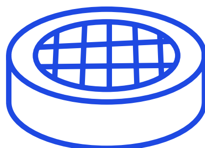
Cost apportionment: Take steps to ensure that costs are equitable among affiliates.

- How are service company cost components and cost allocations split among affiliates?
- What resource units and formulaic methods are used to split costs?
- How equitable are the methods across affiliates?

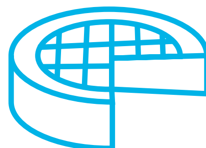
Cost distribution: Demonstrate value for costs charged to affiliates.

- How are service company allocations distributed and communicated to affiliates?
- How are they linked to the value delivered?
- What level of transparency do affiliates have into cost components and cost build up?

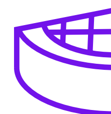
Cost pooling: Adding ingredients and baking the pie



Cost apportionment: Slicing the pie



Cost distribution: Presenting the pie



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Conclusion

Industry-leading cost allocation strategies consider aggregating, apportioning, and distributing costs such that USSC costs are equitably allocated to affiliates with transparency in value of services.

How KPMG can help

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Contact

For more information, please contact:

Ronald Walker
Principal, Finance Transformation Service Network Leader
E: rwalker@kpmg.com
M: 760-703-2076

Kim Huddle
Managing Director, Finance Transformation
E: khuddle@kpmg.com
T: 832-515-7106

Akhil Krishna
Director, Finance Transformation
E: akrishnacm@kpmg.com
T: 609-933-4010

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